

Equity Research

Water & Sustainable Infrastructure

Aqua America, Inc.

WTR - NYSE

Recent Px: \$43.65

Company Update:

Company Delivers Favorable Q2 Results & Outlook; Advise Buying Dips

Investment Summary: Aqua reported solid Q2 results as the company beat our non-GAAP diluted EPS estimate. Many developments transpired during the quarter that are imperative to our model, including a timing discrepancy in the P&L recognition of the Pennsylvania rate case, a delay in the close of the Peoples acquisition, and approval of the large Peoples rate case. As a result, WTR was short of our Q2 top-line estimate, and we were forced to meaningfully modify our model. However, the revision positively affects the model by swinging our 2019 diluted EPS estimate to the top-end of the guidance range from the bottom, and for 2020 and 2021, diluted EPS estimates are essentially the same. On top of these factors, the long U.S. Government bond yield fell over the course of Q2, as well as the five-year WTR beta (according to FactSet). In turn, the stronger 2019 estimated Aqua fundamentals, together with the lower long yield and beta, drive up the valuation multiple, and with our 2020 diluted EPS estimate unchanged, our fair value rises due to the valuation multiple increase. Accordingly, we view the Q2 report and resultant outlook favorably. Still, the stock run-up (along with top water utility peers) the past two weeks on trade tensions, and a falling risk-free rate, is pressing shares against our revised fair value that is at Street-high. Plus, we see the emergence of chatter around Fed rate cutting, and/or a trade truce, contracting the valuation multiple. As such, we see strong potential for a lid to be placed on shares, and for pullback and volatility. That said, our desire to recommend accumulating shares on the solid Q2 report and attractive outlook is offset by valuation. With this in mind, we encourage investors to take a year-end 2020 investment horizon with Aqua and buy dips, because once valuation rolls to 2021 estimates, it becomes compelling once again, and WTR is armed with many catalysts to power the stock to the next year fair value that currently stands at \$51/sh according to our model.

• **Aqua delivers Q2 bottom-line beat.** Q2 non-GAAP diluted EPS of \$0.37 was \$0.03 higher than our estimate. Revenue of \$218.9m was \$7.8m beneath our \$226.7m estimate. The sales difference was a function of timing discrepancy in the model around incorporating the Pennsylvania rate case versus when the rate case went into effect. For simplicity, we plugged an April 1st rate case impact start into the model, yet the rate relief began May 24th. Had we forecasted a one-month recognition of the rate case in the model for Q2, our sales estimate would have matched the Q2 report. On that note, bottom-line outperformance stemmed from better-than-expected other income lines below the line.

• **Flow-through on model revision strengthens 2019 to 2021 earnings estimates and the financial condition.** During Q219, Aqua announced it anticipates closing the Peoples acquisition this fall instead of this summer. Moreover, WTR announced a Peoples rate case outcome of \$59.5m. Going into Q2, we modeled Aqua and Peoples to begin operating as one company in Q319, and we estimated a \$54.1m positive top-line impact, starting in Q419, from the Peoples rate case. Owed to the Peoples developments, we push out the close of the Peoples deal, in our model, by one quarter to Q419, which cuts our Q319 estimates, and we bump up our Q419-start Peoples rate case estimate to \$59.5m to mirror the outcome. We also adjust the Aqua Pennsylvania rate case inclusion in the model to more accurately reflect timing. The model flow-through from these changes, and the update for actual Q2 figures, causes our 2019 non-GAAP diluted EPS estimate to climb by \$0.06 to \$1.50 (top of the \$1.45 to \$1.50 2019 guidance range), strengthening cash generation to a degree that reduces net debt estimates while lifting dividend estimates. Due to the greater 2019 non-GAAP diluted EPS estimate, lower net debt forecast, and higher dividend projection, our target P/E valuation multiple swells. For 2020 and 2021, the model flow-through leads to non-GAAP diluted EPS estimates for each year staying the same. This translates into YoY non-GAAP diluted EPS growth of ~6.5% for each year over the 2019 to 2021 period, implying to us our earnings estimates are on track when considering the Aqua rate base, and consolidated company breakdown, guidance for the Peoples and WTR combined entity.

• **We see stock pullbacks creating investment opportunity.** With our 2019 dividend and non-GAAP diluted EPS estimates rising to \$0.91/sh from \$0.90/sh, and \$1.50 from \$1.44, respectively, combined with the drop in the year-end 2019 consensus 30-year U.S. Government bond yield estimate to 2.5% from 3.0%, and the WTR five-year beta fall to 0.63 from 0.65 (FactSet), our target P/E valuation multiple amplifies to 28.2x from 26.4x. As a result, our fair value increases by \$3 to \$45. We support our valuation with the justified P/B multiple and justified dividend yield approaches that point to fair values of \$45 and \$47, respectively, based on a multiple and yield of 3.2x and 1.95%, respectively. Peeking into next year, our model suggests P/E multiple expansion to 29.9x, and when applied to our 2021 non-GAAP diluted EPS estimate of \$1.70, the 29.9x multiple implies 2021 year-end fair value is \$51/sh. Bearing this in mind, upside to the \$51 mark from the present trading level stands at 16.8%, yet, accumulating shares at the current price sets up for the risk of pullback on current year (2020-based) valuation. Furthermore, we see potential for pullback on the back of easing trade tensions and discussion of Fed rate cuts. To these points, we advise investors to accumulate shares on dips with an investment horizon through 2020 year-end, and as Aqua catalysts come to fruition, we see value in the stock being unleashed to ultimately drive it to the \$51 fair value by end of next year.

Ticker	WTR
Last Price	\$43.65

Valuation Parameters	
Risk-Reward	0.9x
Upside	\$49
Fair Value	\$45
Downside	\$38

Market Capitalization	
Market Cap (\$m)	9,419
Cash (\$m) (2018A)	4
Debt (\$m) (2018A)	2,398
Enterprise Value (\$m)	11,814

Financial Estimates	2018	2019E	2020E	2021E
Rate Base (\$m)	4,500	7,073	7,657	8,246
EBITDA (\$m)	470	576	881	940
EPS	\$1.41	\$1.50	\$1.59	\$1.70
DPS	\$0.84	\$0.91	\$0.98	\$1.06

Valuation	2018	2019E	2020E	2021E
P/E	31.0x	29.1x	27.4x	25.7x
Dividend Yield	1.9%	2.1%	2.2%	2.4%
EV/EBITDA	25.1x	20.5x	13.4x	12.6x

Market Stats	
Shares, FD (2018A)	178m
Short Interest, % Float	530%
Beta	0.63
52 Wk High	\$44
52 Wk Low	\$32
Average Daily Volume (90-Day)	1,051k

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Exhibit 1: Base Case P&LAqua America, Inc.
Income StatementCoker Palmer Institutional
Richard Verdi; 646.827.9586

(in millions except per share data)

December Fiscal Year	FY 2016	FY 2017	FY 2018					FY 2019E					FY 2020E	FY 2021E
Non-GAAP	Year	Year	1Q18	2Q18	3Q18	4Q18	Year	1Q19	2Q19	3Q19E	4Q19E	Year	Year	Year
Revenue	\$819.9	\$809.5	\$194.3	\$211.9	\$226.1	\$205.7	\$838.1	\$201.1	\$218.9	\$244.7	\$473.4	\$1,138.2	\$1,944.9	\$2,015.9
Operating & Maintenance	304.9	287.2	73.9	73.5	68.6	92.4	308.5	79.3	86.4	92.3	239.2	497.2	985.4	995.2
Depreciation	131.0	136.3	36.0	36.6	37.5	36.0	146.0	39.1	39.6	40.1	61.8	180.5	253.7	262.9
Amortization	2.0	0.4	0.1	0.1	0.2	0.2	0.6	0.3	(2.9)	0.2	0.2	(2.2)	0.9	0.9
Non-Income Taxes	56.4	56.6	15.0	14.8	15.6	14.4	59.8	15.0	14.9	16.0	18.8	64.7	78.6	80.6
Operating Income	\$325.6	\$329.0	\$69.3	\$86.8	\$104.3	\$62.8	\$323.2	\$67.4	\$80.9	\$96.1	\$153.4	\$397.9	\$626.4	\$676.3
Interest Expense, Net	(80.6)	(88.3)	(23.5)	(23.7)	(25.4)	(26.3)	(98.9)	(27.9)	(28.9)	(29.8)	(48.6)	(135.2)	(213.5)	(234.2)
Allow. for Funds for Construction	8.8	15.2	2.9	2.6	3.1	4.5	13.0	4.1	3.6	3.9	5.6	17.1	25.1	24.5
Gain on Sale of Other Assets & Other	0.4	0.5	0.2	0.1	0.3	14.3	14.9	6.0	10.9	8.4	8.4	33.7	20.0	20.0
Equity Earnings in JV	1.0	0.3	(0.2)	0.5	(0.1)	(0.1)	0.1	0.5	1.2	0.6	0.3	2.7	1.9	1.5
Income Before Taxes	255.2	256.7	48.7	66.2	82.2	55.2	252.3	50.2	67.8	79.2	119.1	316.3	459.9	488.1
Income Taxes	21.0	16.9	(2.1)	(0.4)	3.9	0.0	1.5	0.5	0.9	1.7	13.2	16.3	51.1	54.2
Net Income (Continuing Operations)	\$234.2	\$239.7	\$50.8	\$66.6	\$78.2	\$55.2	\$250.8	\$49.7	\$66.8	\$77.5	\$105.9	\$299.9	\$408.8	\$433.9
Diluted EPS	\$1.32	\$1.35	\$0.29	\$0.37	\$0.44	\$0.31	\$1.41	\$0.28	\$0.37	\$0.43	\$0.42	\$1.50	\$1.59	\$1.70
Diluted Shares Outstanding	177.8	177.2	178.2	178.3	178.4	178.4	178.4	178.6	178.7	178.8	254.3	197.6	254.9	255.9

Margin Analysis														
Operating & Maintenance	37.2%	35.5%	38.0%	34.7%	30.3%	44.9%	36.8%	39.4%	39.5%	37.7%	50.5%	43.7%	50.7%	49.4%
Depreciation	16.0%	16.8%	18.5%	17.3%	16.6%	17.5%	17.4%	19.4%	18.1%	16.4%	13.1%	15.9%	13.0%	13.0%
Amortization	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	-1.3%	0.1%	0.0%	-0.2%	0.0%	0.0%
Non-Income Taxes	6.9%	7.0%	7.7%	7.0%	6.9%	7.0%	7.1%	7.4%	6.8%	6.6%	4.0%	5.7%	4.0%	4.0%
Operating Income	39.7%	40.6%	35.7%	40.9%	46.1%	30.5%	38.6%	33.5%	37.0%	39.3%	32.4%	35.0%	32.2%	33.5%
Income Before Taxes	31.1%	31.7%	25.1%	31.3%	36.3%	26.8%	30.1%	24.9%	31.0%	32.4%	25.2%	27.8%	23.6%	24.2%
Income Taxes	8.2%	6.6%	-4.4%	-0.6%	4.8%	0.0%	0.6%	0.9%	1.4%	2.1%	11.1%	5.2%	11.1%	11.1%
Net Income	28.6%	29.6%	26.2%	31.4%	34.6%	26.8%	29.9%	24.7%	30.5%	31.7%	22.4%	26.4%	21.0%	21.5%

Growth Rates yr/yr														
Revenue	0.7%	-1.3%	3.5%	4.2%	5.2%	1.2%	3.5%	3.5%	3.3%	8.2%	130.1%	35.8%	70.9%	3.7%
Operating Income	1.4%	1.0%	-0.8%	2.5%	7.0%	-18.4%	-1.8%	-2.7%	-6.7%	-7.8%	144.3%	23.1%	57.4%	8.0%
Income Before Taxes	7.1%	0.6%	-6.3%	-0.5%	3.2%	-5.6%	-1.7%	3.0%	2.3%	-3.6%	115.8%	25.4%	45.4%	6.1%
Net Income	4.9%	2.4%	3.6%	9.2%	2.6%	3.2%	4.6%	-2.2%	0.3%	-0.9%	91.9%	19.6%	36.3%	6.1%
Diluted EPS	4.5%	2.3%	3.4%	9.1%	2.5%	3.1%	4.5%	-2.4%	0.1%	-1.1%	34.6%	6.5%	6.4%	6.4%

Source: Aqua America, Coker Palmer Institutional Equity Research Estimates

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as of 6 25 2019			as of 6 25 2019		
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